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THE EURO: ONLY FOR THE AGILE

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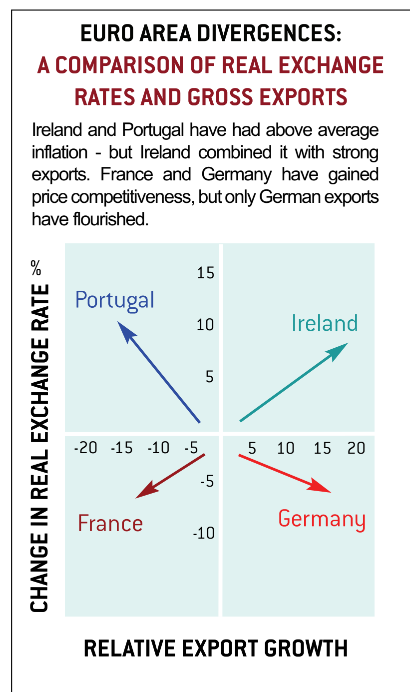
SUMMARY Contrary to often-heard concerns, the main question regarding the future of the European single currency is not who is going to leave, but who is going to join. Three of the new EU member states want to join Economic and Monetary Union (EMU) and adopt the euro within the next year, and others are due to follow within the next decade. **The experience of the first seven years demonstrates that membership has its benefits, but that these benefits are not free. Being part of a currency union requires discipline, and the loss of the exchange rate as an instrument for coping with economic shocks can be costly. Within the euro area some members, such as Ireland, are thriving; others, especially among the southern member states, are struggling and face painful adjustments in the future.** As the chart below illustrates, economic divergences between existing members have been significant. Ireland and Portugal have experienced marked real exchange rate appreciation, but with very different consequences for export growth. There has been real depreciation in both Germany and France, but only Germany's exports have flourished.



EURO AREA DIVERGENCES: A COMPARISON OF REAL EXCHANGE RATES AND GROSS EXPORTS

Ireland and Portugal have had above average inflation - but Ireland combined it with strong exports. France and Germany have gained price competitiveness, but only German exports have flourished.

Source: Eurostat

POLICY CHALLENGE

The policy discussion to date has almost exclusively focused on the implementation of the Stability and Growth Pact. Divergences in growth and inflation have not been given sufficient attention. At the national level, wage and price flexibility in response to economic conditions is essential, and governments must avoid fiscal policies that aggravate divergences. Enhanced surveillance by European institutions of economic performance and policies in euro area member states is also vital. As regards euro area enlargement, policymakers should be ready to apply more sophisticated entry criteria than in the past, even if that entails the risk of being portrayed as "unfair". What is needed is a more refined filter for deciding on membership than the Maastricht criteria. These have proven to be ill-designed to assess whether structural convergence is sufficient to make participation in EMU sustainable.

BY THE END of the decade the euro area may have expanded from the current 12 members to 19 members. The new member states' desire to join EMU is understandable. Membership has its advantages: a monetary anchor, lower interest rates, no speculative attacks on the exchange rate, lower transaction costs, and closer integration with current euro area members.

But these benefits are not free. Being part of a currency union involves discipline, and for the export-dependent participants the loss of the exchange rate as an instrument for coping with economic shocks can be costly.

In retrospect, a lesson from the first seven years of EMU is that those disciplines and potential costs have been underestimated. The policy discussion has almost exclusively focused on the implementation of the Stability and Growth Pact. Persistent divergences in growth and inflation, which we examine in Section 1, have not been given sufficient attention by national and European policymakers. The damaging effects of divergences now call for both painful corrective policies in member economies that have been marred by a loss in competitiveness (Section 2), and for the introduction of a stronger surveillance framework to prevent similar problems arising in the future (Section 3).

There are also lessons to draw for the new member states (Section 4). Given their level of development, the economic structures and financial systems in the new member states will continue to change as they converge to income levels in the EU-15 countries. These changes may require significant real exchange rate adjustment if the new member states are to maintain international competitiveness and prevent deep recessions and bouts of high inflation. Within EMU, real exchange rate adjustment can only be brought about through changes in domestic prices and wages. Beyond the nominal entry criteria spelled out in the Maastricht treaty, the key questions, therefore, are to what extent the new member states are at risk of being hit by severe asymmetric shocks, and whether they can adjust to such shocks through internal flexibility. In deciding who is fit for membership in the single currency, the EU should avoid hiding behind ill-designed nominal criteria and address these questions explicitly.

1. PERFORMANCE MEASURES

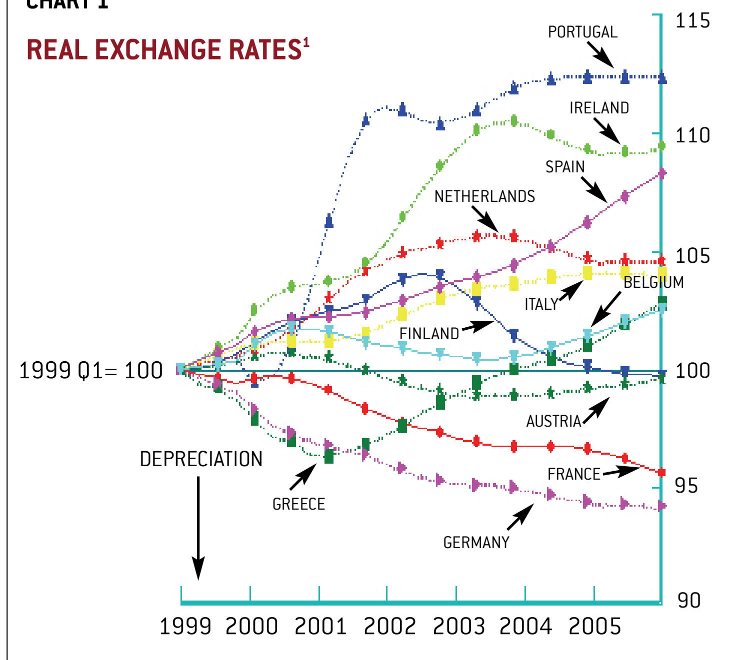
Some countries have fared better than others under EMU. Table 1 documents the differences in real GDP growth rates across the euro area since 1999. Growth in Ireland, Greece and Spain has significantly outpaced average euro area growth, while Germany, Italy and Portugal have underperformed. Strong growth in Spain and Greece has been driven by robust domestic demand, whereas their export performance has been mediocre. Weak net exports have

TABLE 1. REAL GDP GROWTH
(Annual avg. 1999-2005)

		Contributions from:	
	Real GDP	Domestic Demand	Net Exports
Ireland	6.3	4.4	1.9
Greece	4.1	4.5	-0.4
Spain	3.6	4.6	-1.0
Finland	2.7	1.9	0.8
France	2.2	2.6	-0.4
Belgium	2.0	1.7	0.3
Austria	2.0	1.4	0.6
Netherlands	1.6	1.2	0.4
Portugal	1.5	1.8	-0.3
Italy	1.3	1.5	-0.2
Germany	1.2	0.4	0.8
Euro Area	1.9	1.8	0.1

Source: Eurostat

CHART 1
REAL EXCHANGE RATES[1]



Source: OECD

[1]Intra euro area real trade-weighted exchange rates, based on Consumer Price Indices.

also depressed growth in Italy and Portugal, along with sluggish domestic demand. Remarkably, German domestic demand has barely grown since 1999, and the moderate growth that Germany has registered has been entirely due to net exports.

The dispersion of growth rates across euro area countries is not especially large, being similar in size to the dispersion across the US[2]. Unlike in the US, however, growth differentials in the euro area are persistent, and evidence shows that it is the trend rate of growth that drives these differentials, rather than countries simply being at different stages in the output cycle. In fact, business cycles have become strongly synchronised in the euro area[3].

> *"Savings and investments have become increasingly decoupled in EMU countries."*

Persistent differences in inflation rates across countries are another feature of the euro area. Here also, at any point in time the dispersion of inflation across the euro area is not unusually large; but, as a result of prolonged differences in inflation rates, euro area economies have experienced very sizeable swings in their real exchange rates vis-à-vis their peers, as shown in Chart 1. These inflation differentials largely reflect domestic factors, especially growth in wages, and are highest in the non-traded goods sector.

Generally speaking, countries with the strongest growth in domestic demand also registered the highest rates of inflation (Chart 2). Portugal is the only notable exception.

The changes in competitiveness resulting from these movements in real exchange rates appear to have played a role in bringing about large swings in current account balances in several countries. Portugal and Spain are now running large current account deficits, while Germany and several other higher-income countries are running large surpluses. As savings and investment have become increasingly decoupled in EMU countries, the dispersion of current account balances has trended up over the last 15 years (Chart 3).

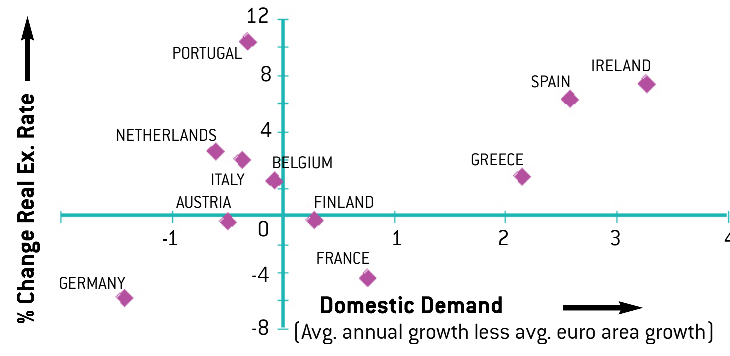
2. PROBLEM COUNTRIES

It is important to note that growth and inflation differentials are not undesirable per se. Whether the observed differences are desirable or undesirable depends in large part on the nature of the shocks that are causing the divergences. In a currency union with different economies and asymmetric shocks, some divergence between members is to be expected and is even necessary. Distinguishing welcome from unwelcome differentials requires case-by-case economic analysis of initial conditions and underlying factors.

The two countries with the highest inflation rates, Ireland and Portugal, are a case in point. In Ireland, real exchange rate appre-

CHART 2

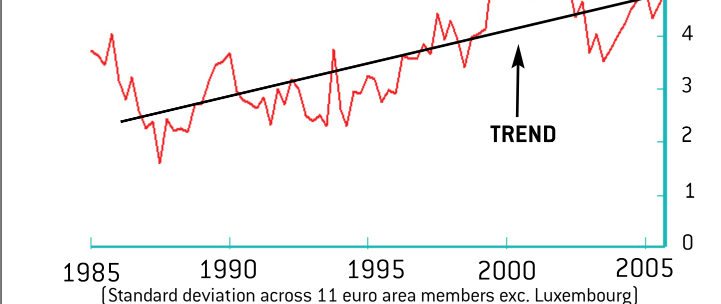
REAL EXCHANGE RATE AND DOMESTIC DEMAND (1999-2005)



Source: OECD

CHART 3

CURRENT ACCOUNT DISPERSION



Source: Eurostat

[2] See Angeloni and Ehrmann (2004) and Gonzalez-Paramo (2005).

[3] See Lane (2006) and de Bandt, Herrmann and Parigi (2006).

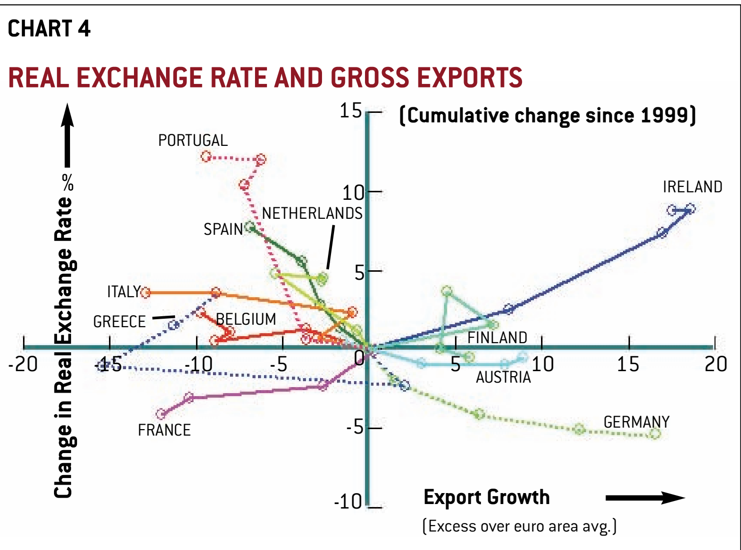
ciation has been offset by rapid advances in productivity and movements up the value chain in the traded-goods sector. As a result, Ireland's competitiveness has not suffered, as witnessed by the boom in exports (Chart 4).

In contrast, above-average inflation has led to a marked deterioration in Portugal's competitiveness, which has depressed exports. Portugal enjoyed a spurt in growth in domestic demand and in the construction sector around the time of EMU entry, as real interest rates declined by more than 6 percentage points and credit to households expanded rapidly. Budgetary policy added to the expansion because the benefits from a reduced interest debt burden were entirely passed on to private agents. However, the honeymoon was short-lived as the loss of competitiveness eventually began to dominate.

Chart 4 illustrates the situations of the other EMU members that have also had above-average inflation. Italy bears a strong resemblance to Portugal, with sluggish domestic demand and weak exports. Importantly, slow productivity growth and the composition of Italy's and Portugal's exports left them vulnerable to international competition

CHART 4

REAL EXCHANGE RATE AND GROSS EXPORTS



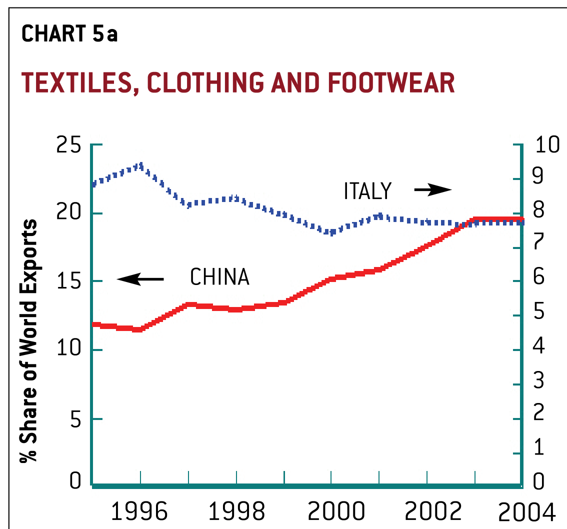
Source: Eurostat

BOX 1: THE "CHINA SHOCK" TO ITALY AND PORTUGAL

An important factor behind the current economic problems in Italy and Portugal is the lack of structural transformation that has left both countries vulnerable to competition from low-cost producers, especially China and the new EU member states. Italy and Portugal entered EMU with industrial structures that placed them directly in China's line of fire. As shown in the charts below, both countries have suffered declines in market share of key export products at the same time as China's share of these markets has surged. Membership of EMU has both exacerbated the loss of competitiveness and narrowed the policy options for responding to the external shocks that have buffeted both economies.

CHART 5a

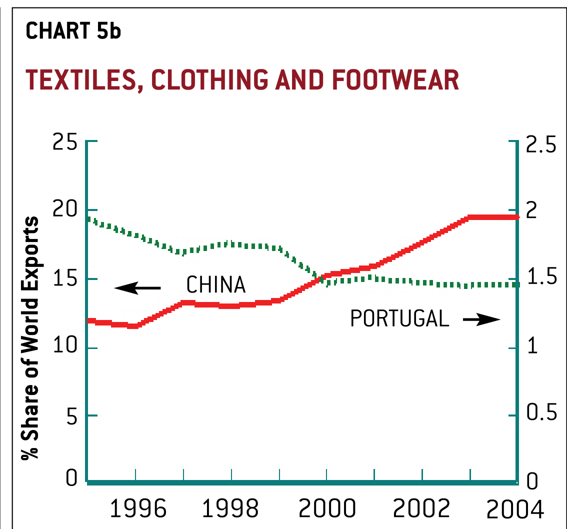
TEXTILES, CLOTHING AND FOOTWEAR



Source: UNCTAD

CHART 5b

TEXTILES, CLOTHING AND FOOTWEAR



Source: UNCTAD

from low-cost producers, especially China (see Box 1). Adjustment to global shocks would have required real exchange rate depreciation in Italy and Portugal, not the real appreciations that both countries experienced. In both countries, restoring competitiveness will require a prolonged period of below-euro-area-average growth in unit labour costs.Greece and Spain have also perforccmed relatively poorly when measured by exports. To date, robust domestic demand, driven in part by activity in the construction sector, has more than outweighed weak exports. Our concern is that when the temporary boost from the EMU-induced drop in real interest rates and rising property prices eventually fades, they may well be facing similar problems to those Portugal is facing today.

At the other end of the scale is Germany, where persistent excess capacity in the economy, because of weak domestic demand, has kept inflation below the euro area average. With a common nominal interest rate across the euro area, below-average inflation has resulted in above-average (ex-post) real interest rates in Germany, which has further depressed domestic demand and inflation (see Box 2).

Below-average inflation has set in motion an economic force that works to offset the drag from high real interest rates: German exporters have become more competitive—the so-called "competitiveness channel" of adjustment—and German exports have surged. Over time, the competitiveness channel may come to dominate the depressing effect of high real interest rates, but the German case shows that this adjustment process takes a damagingly long time, even in a highly open economy. The announced 2007 tax hike should further delay the revival of domestic demand.

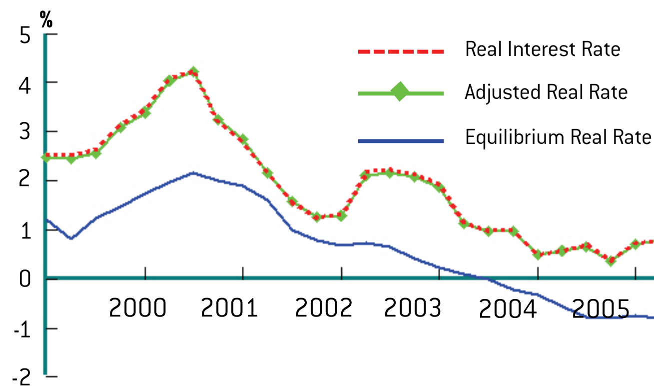
BOX 2: REAL INTEREST RATES IN GERMANY

Real interest rates in Germany have declined from their peaks in 2000, as the ECB cut nominal interest rates and as German inflation picked up a little from very low rates. However, we estimate that the German "equilibrium" real interest rate—that is, the real interest rate that would provide enough stimulus to demand to use up spare capacity in the economy—has also declined over recent years, so that the level of real interest rates has remained restrictive (see Chart 6 below). Given the large amount of economic slack at present, we estimate that, other things being equal, negative real interest rates in Germany would be needed to close the output gap[4] over the next few years.

The calculations above are based on German Consumer-Price-Index (CPI) data. Domestic consumer prices are clearly relevant for households' consumption and savings decisions, but less relevant for exporting firms' investment decisions. In Chart 6 we plot an alternative measure of the German real interest rate based on a weighted combination of domestic and foreign prices, where the weights reflect the size of exporters' investment spending in aggregate expenditure. The closeness of the two measures suggests that, contrary to some claims, using domestic price indices can result in accurate calculations in real interest rates.

CHART 6

GERMAN REAL INTEREST RATES



Source: IMF, UNCTAD, own calculations.

[4]The output gap is the difference between actual and potential GDP.

3. POLICY IMPLICATIONS FOR CURRENT MEMBERS

Economic problems in EMU member states are not only a matter for national governments. Even putting aside the risk of an eventual break-up, they are a common concern for the whole euro area. Difficulties in individual euro area countries spill over and affect other EMU member states via two channels.

- Financial linkages. EMU member states are exposed to developments in the rest of the euro area through large and growing cross-border holdings of assets. For example, recent data show that other euro area member states hold about €70 billion in Portuguese assets and thus would suffer significant negative wealth effects should the value of these assets decline markedly.

- Monetary policy. Very low inflation, or even deflation, in one EMU member country undergoing disinflationary adjustment pulls down average euro area inflation. In response, the European Central Bank would run a more expansionary monetary policy than would otherwise be the case. The resulting looser monetary conditions would push up inflation in other EMU member states, leading to greater divergence.

A. WHAT TO DO AT THE NATIONAL LEVEL.

For the countries in EMU with the severest problems, i.e. Portugal and Italy, there can be no solution other than the long, hard slog of structural adjustment. The first priority should be to make sure that divergence does not become any worse. This calls for wage moderation and increased competition in goods and services markets to bring inflation down below the euro area average.

Other members of the euro area should also implement policies to improve the functioning of adjustment mechanisms. In the short run, these reforms may be especially important for Spain and Greece, given the concerns we have mentioned about these economies. In the medium run, these reforms matter for all euro area members.

First, the "competitiveness channel" through which a loss of price competitiveness generates economic slack that eventually corrects the real appreciation needs to be strengthened. Particularly important in this regard is a wage formation process that makes wages respond swiftly to economic conditions. Increased competition in product markets should also increase the responsiveness of domestic prices to shocks. The completion of the single market for services would help in this regard.

Second, it is clear that built-in fiscal stabilizers should be allowed to work fully and that national governments should avoid pro-cyclical fiscal policies that aggravate divergences. Portugal's experience suggests that the fiscal discipline in place during the pre-EMU years can easily be thrown aside once the goal of EMU entry has been achieved. In the countries that need to undergo a real exchange rate adjustment, fiscal policy should be geared towards supporting it.

> *"The European Commission should use its right of alert to single out problem countries."*

Third, there may be a role for enhanced prudential and regulatory policies to help avoid asset price booms and busts in individual member countries. In particular, tighter regulations on household borrowing might be desirable in some countries experiencing credit booms. At the very least, careful monitoring of credit expansion is essential to prevent an overshooting of domestic prices, especially for those members who have to adjust to lower interest rates than they have historically been accustomed to.

Finally, the euro area should avoid putting itself in a situation where its members pursue inconsistent goals. In this respect, further depreciation of Germany's real exchange rate vis-à-vis the rest of the euro area would be inconsistent with the need to restore price competitiveness in several other countries.

B. INSTITUTIONAL DIMENSIONS.

As well as changes in polices at the national level, changes at the Community level in how problems in individual member states are approached are also needed. Enhanced surveillance by European institutions of economic performance and policies in euro area member states is vital. Such monitoring would aim to identify problems in individual member states that could spill over into the rest of the euro area.

Currently, multilateral surveillance in the euro area has two arms: a relatively strong one, the Stability and Growth Pact (SGP); and a relatively weak one, the monitoring of economic policies under Article 99 of the Treaty. Budgetary surveillance under the SGP aims at containing fiscal imbalances that are a source of harmful divergence. However, monitoring member states' fiscal positions is not sufficient. After all, Spain is currently running a small fiscal surplus. Moreover, Portugal made significant policy mistakes during the period 1995-1999 at a time when its headline budget deficit was declining from 5 per cent to below 3 per cent.

There is therefore a need to strengthen the "weak" arm. First, the European Commission should speak up and use its so called "right of alert" to single out problem countries. Bank of England Governor Mervyn King recently reminded us[5]

[5] In his speech on the future of the IMF of 20 February 2006.

that Keynes placed faith in "ruthless truth-telling" and this should apply to the Commission. Second, the Eurogroup should have frank discussions on potential problems and remedies and make sure that their conclusions are brought to the attention of the relevant governments. The treaty-based community instrument, the so-called Broad Economic Policy Guidelines (or the newly adopted Integrated Guidelines) is too weak to be relied upon, and plays virtually no role in the national policy debates. Therefore, whenever needed, the President of the Eurogroup should be given the mandate to engage in direct discussions with national governments. Finally, the specific euro-area dimension of structural surveillance – which is associated with the Lisbon Agenda – should be strengthened. At least, the list of reform priorities should explicitly include measures that are needed to improve the functioning of EMU.

4. POLICY IMPLICATIONS FOR NEW EMU APPLICANTS

Our analysis also throws light on the issue of euro area enlargement. As shown in Charts 7 and 8, many of the new EU member states have experienced solid growth in domestic demand as well as considerable real exchange rate appreciation vis-à-vis current euro area members and a boom in exports. On these dimensions, they have more in common with Ireland than with Portugal.

At first glance, therefore, our data deliver an optimistic assessment. In judging whether EMU membership is right for the new EU member states, however, there are other dimensions that need to be considered.

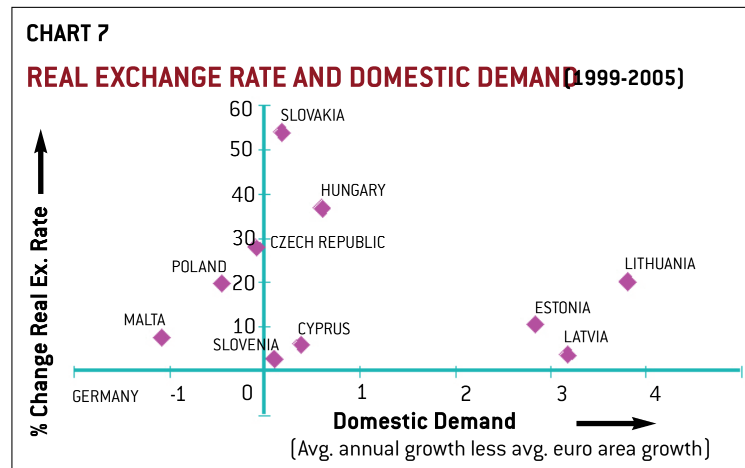
First, compared with current EMU members, the potential benefits for the new EU member states of joining EMU are greater, but so too are the potential costs. The new EU member states probably face larger asymmetric shocks, and this matters, even though they have more flexible economies than the current members.

Second, the Maastricht criteria based on inflation, long-term interest rates, exchange rate stability and public finances are neither necessary nor sufficient to determine suitability for EMU membership. They are not necessary because higher inflation can be a consequence of rapid economic catch-up. They are not sufficient because satisfying the price stability criterion in the run-up to EMU entry does not guarantee that inflation will remain low once membership has been achieved. In a similar vein, the fiscal discipline displayed prior to EMU entry can easily disappear once in the euro area, especially if budgetary accounting tricks were used to satisfy the criteria on government deficits and debt.

Third, real convergence matters. Here, the new member states' record is more mixed. Trade and foreign direct investment (FDI) integration with current EMU members has progressed quickly in recent years and is now fairly advanced. However, output per capita remains far below the average euro-area level, and convergence in output specialisation to EU norms has been slow: significantly, agriculture and manufacturing still weight more than in the current EMU members, and services are relatively underdeveloped. As convergence

CHART 7

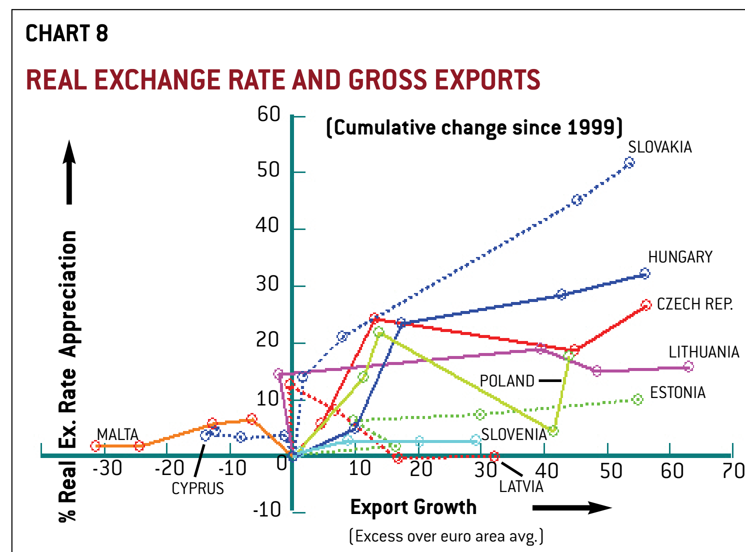
REAL EXCHANGE RATE AND DOMESTIC DEMAND (1999-2005)



Source: OECD

CHART 8

REAL EXCHANGE RATE AND GROSS EXPORTS



Source: Eurostat

proceeds further, real exchange rates may have to adjust, especially in the context of changing world trade patters as a consequence of the rise of China.

It is frequently argued that the new EU member states should be judged solely on the basis of the Maastricht criteria because these were the yardsticks applied to the current members. But EMU is a learning process, and we have learnt that nominal convergence is not enough to ensure that a country is fit for the euro. Furthermore, Article 121 of the Treaty explicitly mentions that "a high degree of sustainable convergence" is a condition for membership. This should be taken as a basis for a broad assessment of a country's effective and lasting ability to participate in the single currency.

"EMU is a learning process; nominal convergence is not enough to ensure that a country is fit for the euro."

One feature of the recent performance of the new member states has been their large current-account deficits. In large part, deficits reflect high prospective returns on investment in these countries as a result of their low capital-labour ratios. Tellingly, much of the capital inflow has taken the form of FDI, which may limit vulnerability and has facilitated technology transfer. However, convergence towards a steady state where external liabilities represent a constant proportion of GDP would imply for some countries an adjustment in the trade balance of the order of magnitude of 5 per cent of GDP or more[6]. This again raises the issue of the corresponding real exchange rate adjustment.

To be sure, EMU entry should accelerate the process of real integration. In turn, increased trade integration with greater intra-industry trade should lead to increased synchronisation of business cycles with fewer asymmetric shocks. However, this process takes considerable time. Prudent macroeconomic polices and microeconomic reforms will be needed to facilitate these advances. But convergence is rarely smooth, and substantial real exchange rate adjustments may be required along the way.

The question, therefore, is not whether EMU is suitable only for rich countries. The level of per-capita real GDP in itself should not be a criterion for entry into EMU. The deciding question should be whether countries for which the potential for divergence is significant have taken the necessary measures to minimise this risk.

It is illusory to believe that a well-functioning single currency area can emerge spontaneously; members have to work hard to make it happen. A reformed and enlarged EMU offers the potential of enormous benefits, but only for those countries that are willing to get into shape.

We thank Narcissa Balta for her assistance in preparing this Policy Brief.

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[6] See Lane and Milesi-Ferretti (2006)